



HOUSE BUDGET COMMITTEE

Democratic Caucus

The Honorable John M. Spratt Jr. # Ranking Democratic Member

214 O'Neill HOB # Washington, DC 20515 # 202-226-7200 # www.house.gov/budget_democrats

December 13, 2001

Republican Stimulus Proposals Make a Bad Situation Worse

"It is, regrettably, my conclusion that we are unlikely to return to balance in federal accounts before, possibly, fiscal [year] '05. Things will have to break right for us to do that."

OMB Director Mitchell Daniels
November 28, 2001

"In order to address an economic slowdown, we brought sorely needed fiscal discipline to Washington, D.C. We fought for and got a budget that was realistic, that didn't grow way beyond the means of our government."

President George W. Bush
November 28, 2001

Republicans' fiscal mismanagement has reversed eight consecutive years of fiscal improvement, turning growing surpluses into persistent deficits and depleting the resources that underwrite Social Security and Medicare. Republicans' response to this blunder is to call for more of the same medicine—an economic stimulus package composed of permanent tax breaks with large long-term costs. President Bush's approach to stimulus—reaffirmed as his Budget Director was breaking the bad news that the surplus had vanished—imposes significant long-term budgetary burdens by spending the Social Security and Medicare surpluses, while doing little to stimulate the economy.

This report analyzes three issues: (1) why the Republican stimulus proposals will be such a large drain on the surplus; (2) how the surplus drops further after realistic assumptions are made about future spending and tax cuts; and (3) how a revised long-term outlook could lower the surplus still further.

Making a Bad Situation Worse

The Administration's response to the recession has been to insist on permanent tax cuts that will remain in effect long after the recession has ended—on top of those already enacted. This will eat further into the Social Security and Medicare surpluses. On November 29, the President set forth

his goals for a stimulus package. He wants the cuts in tax rates for upper-income taxpayers that have yet to take effect to be implemented immediately. He also insisted that the corporate alternative minimum tax (AMT) be permanently repealed. Finally, he said that a stimulus package must include a corporate tax break for enhanced expensing of investments.

This creates a political dynamic in which even the package's temporary tax breaks would become a permanent drain on the budget. The President's proposal to eliminate the corporate AMT is, of course, a permanent tax cut. There also would be tremendous pressure to make permanent the three-year period for enhanced expensing of investment that most Republicans seem to favor, because not doing so could result in a large drop in business investment after the incentive ended. Bringing forward the tax rate cuts for upper-income individuals would make it quite difficult ever to freeze tax rate cuts should future budget pressures warrant it. In fact, the President, senior Administration officials, and the Republican leadership in Congress have repeatedly argued that both enhanced expensing and cutting tax rates for upper-income individuals should be permanent.

The danger with this approach is that the true cost of a Republican stimulus could end up reducing the projected ten-year budget surplus by more than half a trillion dollars. For instance, the table below shows that H.R. 3090, which Republicans pushed through the House on a virtual party-line vote and which the President has lauded, could be significantly more costly than advertised. If one assumes that the rate cuts and the expensing provisions in H.R. 3090 became permanent, as Republicans desire, it would reduce the ten-year surplus by as much as \$653 billion.

How Much Would H.R. 3090 Really Cost?

Billions of Dollars

| | <u>2002</u> | <u>2002-11</u> |
|--|-------------|----------------|
| Direct Cost of H.R. 3090 | 101 | 162 |
| <i>Plus:</i> | | |
| Effect of Permanent Expensing for Investment | 0 | 210 |
| Effect of Repealing Bush Tax Cut Sunsets in 2010 | 0 | 113 |
| Debt Service | 2 | 168 |
| <i>Equals:</i> | | |
| Cost of H.R. 3090 With Permanent Provisions | 103 | 653 |

Ignoring the Inevitable

Democrats have consistently argued that the basic problem with Republicans' budgeting is that they ignore inevitable claims on future surpluses and inevitable risks in order to make it appear that tax cuts for all occasions are affordable. Again and again, Republican Congresses and Presidents

have put forward “budgets” that ignore foreseeable needs with major budgetary costs. For example, President Bush offered a “budget” earlier this year that:

- budgeted no money at all for either the President’s proposed defense buildup or a farm bill,
- projected non-defense appropriations to shrink in real terms for ten years, and
- wished away the need to renew expiring tax provisions and fix the individual alternative minimum tax (AMT).

When challenged to explain how such a “budget” can hold together, Republicans routinely promise that, at some point in the future, they will cut spending for wasteful programs, though what and when are never specified.

What happens to the projected surplus if we recognize the inevitability of many priorities not in the baseline? The table below shows the effect of very conservative assumptions about future claims on the surplus over the next ten years.

How Much Surplus Is Realistically Left?

Billions of Dollars

| | <u>2002</u> | <u>2002-11</u> |
|---|-------------|----------------|
| October Unified Surplus | 52 | 2604 |
| <i>Less:</i> | | |
| H.R. 3090 With Permanent Provisions | 103 | 653 |
| Farm Bill (House-Passed) | 7 | 71 |
| Education Bill (Senate-Passed) | 0 | 146 |
| Average Cost of Natural Disasters | 2 | 55 |
| Permanent Renewal of Expiring Tax Provisions | 1 | 142 |
| Fix AMT Interaction with Bush Tax Cut | 0 | 208 |
| Nondefense Appropriations Growth at 2 Percent | 0 | 59 |
| Debt Service | 0 | 138 |
| <i>Equals:</i> | | |
| Remaining Unified Surplus | -61 | 1518 |

The claims on the surplus that the table illustrates are not speculative. Congress will pass and the President presumably will sign both a farm bill and an education bill. Natural disasters inevitably will occur, and the Federal government inevitably will respond. Popular tax credits that the

Congress has always renewed will be renewed again. The Congress will not allow the Bush tax cut to subject over 35 million taxpayers (about one of every three taxpayers with positive tax liability) to the alternative minimum tax. Surely, nondefense appropriations will grow by at least 2.0 percent per year after adjusting for inflation, a pace well below the 2.7 percent averaged over the last 40 years.

Taking all of these factors into account, on top of the Bush tax cut and Republican stimulus proposals, reduces the unified surplus over ten years to only \$1.5 trillion. In this event, about 40 percent of the Social Security surplus over ten years would be consumed—just before the Baby Boom generation begins to retire.

The Danger That the Surplus Will Be Revised Down

At first blush, the bottom line of the table above doesn't look too bad. It shows unified deficits and rising public debt for the next two years. After that, though, surpluses appear to grow again, though not enough to set aside the Social Security and Medicare surpluses to prepare for pending long-term fiscal challenges.

Unfortunately, we are learning that surplus projections can be revised down as well as up. In recent years, the Congress has become accustomed to seeing CBO's ten-year projections routinely revised up by as much as a trillion dollars. Republicans' budget resolutions for the last two years actually have built in the assumption that mid-year re-estimates of the budget would necessarily be positive. Now, though, there is good reason to believe that the official ten-year projected surplus will be revised down, not up.

OMB Director Daniels seemed to be acknowledging this when he suggested that there will be unified deficits until 2005. In his remarks, he noted that private-sector economists were revising down their previously rosy ten-year outlook and that this will have a depressing effect on the projected surplus. Indeed, CBO's analysis of their own past forecasting errors suggests that there would normally be about a one in three chance that a downward revision, on top of the cost of the Republican stimulus proposals and inevitable further claims on the surplus, would lead to unified budget deficits for as far as the eye can see.

There are good reasons to expect that revisions of the surplus in coming months will be negative. As Director Daniels pointed out, long-run GDP growth may be weaker. For one thing, resources will have to be diverted from production to security. In addition, forecasters now expect weaker business investment even after the recession has ended, and that will hold down productivity growth.

In addition, the amount of revenue generated by every dollar of GDP is likely to decline sharply in the short run and may not recover much in the long run. The ratio of revenues to GDP had risen to record levels, and until recently both OMB and CBO had assumed that it would retreat only modestly. However, with weaker growth of income tied to the stock market—like capital gains,

stock options, executive compensation, and bonuses—the revenue from such sources may well reverse its earlier disproportionate growth.

Even small changes in the ratio of revenues to GDP can have major impacts on the budget. Yet, such small changes in the ratio happen all the time. That is why Republicans' approach to budgeting and economic stimulus represents such a gamble. Passing permanent tax cuts with exploding long-term costs, pretending that spending will be cut like never before, wishing away inevitable claims on the surplus like natural disasters, and leaving no room for error in an inherently uncertain world are a recipe for recurring fiscal crises.